

**International Baccalaureate**

**Diploma Programme**

**Economics**

**Higher level paper 1**

**(For first teaching 2011, first examinations 2013)**

HL P1 economics specimen paper exemplar scripts			
Script	Question	Marks	Notes
A	1 (a)	8	
	1 (b)	15	
B	1 (a)	7	
	1 (b)	8	
C	3 (a)	9	
	3 (b)	12	
D	3 (a)	3	
	3 (b)	3	

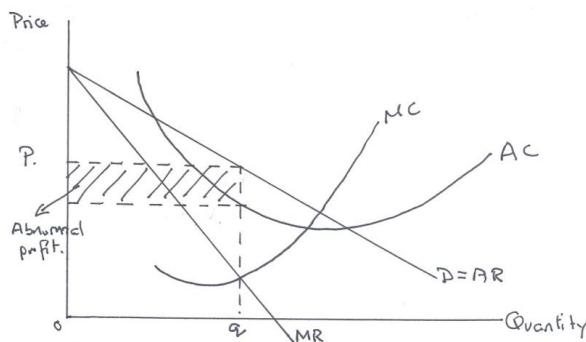
## HL P1 SAMPLE A

1. (a) Explain why firms in monopolistic competition can make economic profit in the short-run only.

Monopolistic competition is a type of market structure in which the following assumptions can be made; there are a large number of firms, the factors of production are perfectly mobile in the long run, there is almost perfect knowledge, there are no significant barriers to entry and the product is differentiated.

In the short run, a monopolistically competitive firm is able to make abnormal profits as shown below.

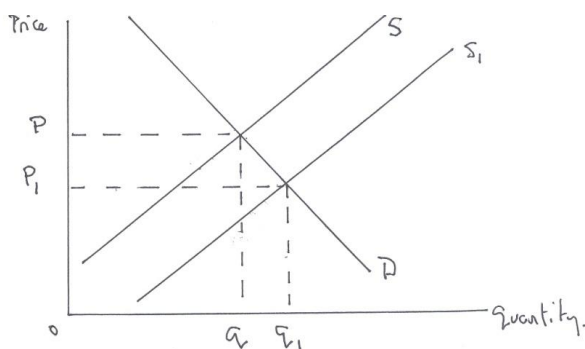
**Comment [A1]:** This needs a definition.



At a price of  $p$  and at a quantity of  $q$  the price is higher than the average cost (AC) and thus, the monopolistic firm is making abnormal profit.

**Comment [A2]:** Refers to the diagram.

However in the long run, other firms then enter the market attracted by the abnormal profits and because there are no significant barriers to entry.



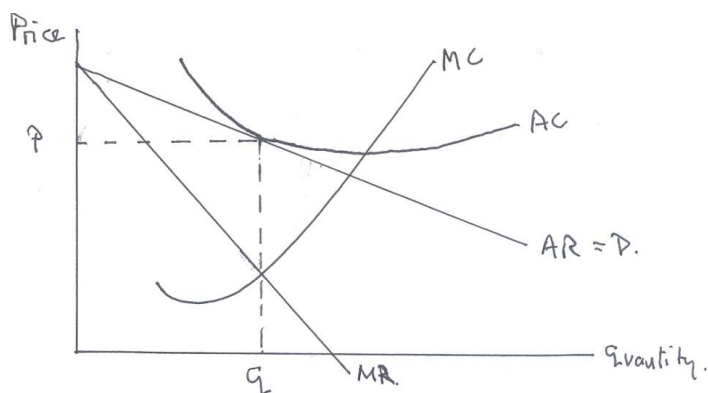
**Comment [A3]:** While this is an acceptable diagram for the market, it does not explain why the demand falls for individual firms, and so why abnormal profit is eroded in the long-run.

As shown in the diagram, because other firms enter the market, the supply curve shifts from  $S$  to  $S_1$ , and as a result the price falls from  $p$  to  $p_1$ . This can be depicted in a new diagram representing the monopolistically competitive firm in the long run.

**Comment [A4]:** Refers to and explains what is happening in the diagram.

Because the price has fallen, the AC is now equal to the AR resulting in normal profit for the long run.

**Comment [A5]:** Refers to the diagram.



This can be seen in the Italian Restaurant business in Jakarta, at first there were a few and highly priced restaurants. However more have opened and prices are significantly lower than they used to be. So the abnormal profits that were being made have been removed by additional competition.

**Comment [A6]:** There is an absence of definitions. Relevant economic theory is clearly explained and applied. Diagrams are included and applied to the question. There is an example though it is not well developed.

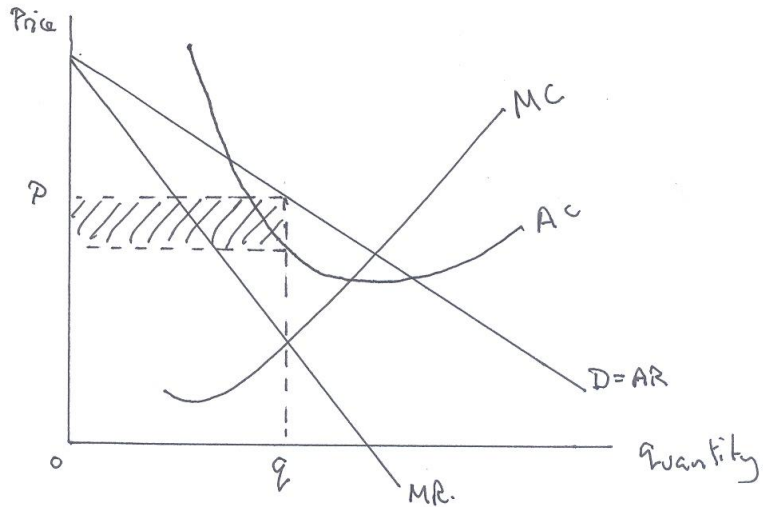
(b) Compare **and** contrast the market structures of monopoly and monopolistic competition.

**Comment [A7]:** Level 3 8/10 marks.

Monopolistic competition and monopoly are both types of market structure and they both face a downward sloping demand curve. However the characteristics of each are very different. The main difference is that in monopolistic competition there are a large number of firms whereas in a monopoly one firm supplies the market, although the legal definition is a little different. This is caused by the barriers to entry which are present. In monopolistic competition there are no or very low barriers to entry so firms are able to enter and leave the market. This has the effect of removing both abnormal profits and losses in the long run. In monopoly however there are significant barriers to entry. These can take various forms, one legal barrier would be the existence of patents and copyright, this restricts other firms from producing the same product. The electricity provider in Indonesia is a legally protected state monopoly. A firm might also be a natural monopoly where significant economies of scale have led to its emergence. Monopolies therefore are able to make abnormal profit in both the long run and the short run, something that monopolistically competitive firms cannot.

**Comment [A8]:** An example is provided.

Diagram showing a monopoly earning abnormal profits in the long run.



Because no other firm enters the market, the monopoly profit maximises at a price of  $P$  and a quantity of  $Q$ . The shaded area represents the abnormal profit they are able to gain, even in the long run. However there are some similarities as well, both set their price and output at a level at which they are neither productively efficient, which is defined as the level of production at which average cost is minimised or equal to marginal cost, nor allocatively efficient. Allocatively efficient is defined as the level of output where marginal cost is equal to average revenue this regarded as the optimal level of resource allocation as defined by society. Also neither monopoly nor monopolistic competition are price takers, although there is much more control over price in a monopoly.

**Comment [A9]:** Some explanation of the diagram.

**Comment [A10]:** A definition is given.

In conclusion, monopolies and monopolistically competitive firms are similar in that they both have control over price and so they are price makers rather than price takers. They also both set prices at the level of profit maximisation. However the main difference is that only one firm dominates the market in a monopoly due to the very significant barriers to entry that exist. Monopoly can earn abnormal profits in the long run whilst monopolistic competition cannot. Also because a monopoly is a single firm, they have a lot of control over price, and thus the consumer surplus will be reduced, there is also the possibility that they become less efficient and produce at a lower quality as there is no incentive for them to be efficient. This differs from monopolistic competition because while they do have control over price they face competition.

**Comment [A11]:** Response is clearly focused on the similarities and differences between the two market structures as stressed by the question. Relevant economic theory is clearly explained and applied to the question. There is an attempt to provide definitions.

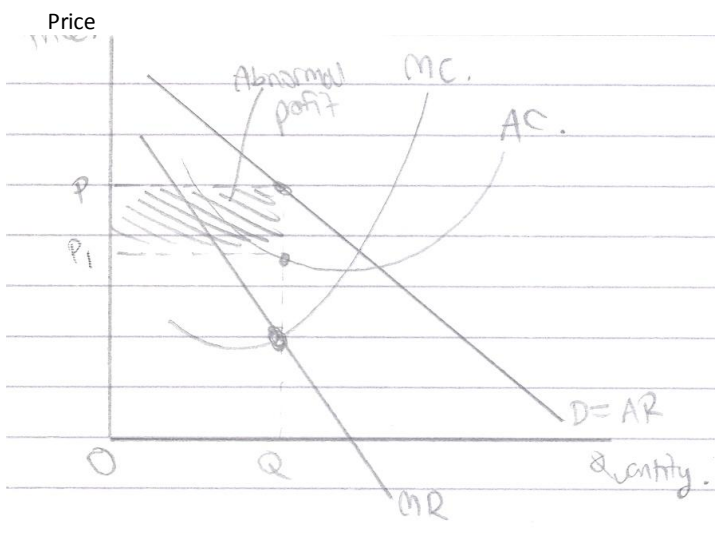
**Comment [A12]:** Level 4 15/15 marks.

## HL P1 SAMPLE B

1. (a) Explain why firms in monopolistic competition can make economic profit in the short-run only.

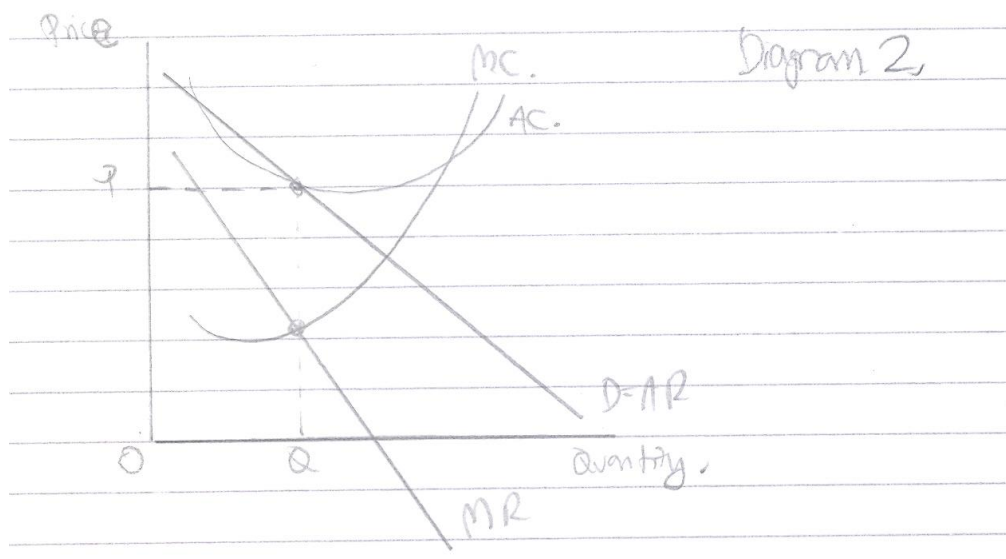
Firms in a monopolistic market can only make abnormal profit in the short run. Abnormal profit is when the average revenue of the firm exceeds the average cost. A monopolistic market has many firms who are able to produce a differentiated good and therefore able to set their own prices to a certain extent. Due to this fact their demand curve is not completely horizontal such as that of a perfectly competitive market. In the long run however firms in this market cannot make abnormal profit. Instead they can make normal profit where their average cost is equal to their average revenue. This is due to competition with other firms. The diagram below will help illustrate abnormal profit in the short run.

**Comment [A13]:** Definition.



**Comment [A14]:** The diagram is referred to and explained.

The diagram above shows abnormal profit in the short run for a monopolistic market. The firm will choose to produce where MC (marginal cost) is equal to MR (marginal revenue) to profit maximise. At this level of output ( $q$ ) the price ( $p$ ) is determined from the downward sloping demand curve. At that level of output, the average cost price is lower than the average revenue price and therefore the gap between  $p$  and  $p_1$  is the abnormal profit. An example of a monopolistic firm is an Italian restaurant. There may be many Italian restaurants in a city yet their products may be differentiated, each restaurant will not have exactly the same dishes with the same taste. Therefore such restaurants can charge different prices to their competitors because they have a quality that others do not. In the short run this Italian restaurant would be able to produce abnormal profit if their AR exceeds their AC but not in the long run. Theoretically abnormal profit is impossible to obtain in the long run because other firms will be attracted to enter the market if they can obtain abnormal profits. For example, if the Italian restaurant is doing well financially by making lots of profit, new restaurants will come because they will also want such profits. The diagram below will illustrate the long run profit of a monopolistic market.



**Comment [A15]:** The diagram is not precise, MC does not cut AC at minimum and AC is not tangential to AR, but the diagram is referred to and used to answer the question.

Above we can see that there is only normal profit because at the profit maximising output of  $MC=MR$ , at price  $P$  and quantity  $Q$ , the average cost equals the average revenue. With more firms coming in the original Italian restaurant will lose demand and so their average revenue will decrease which is why abnormal profit can only be attained in the short run with normal profit in the long run.

(b) Compare and contrast the market structures of monopoly and monopolistic competition.

A monopoly occurs when there is only one sole provider of a good that has no close substitutes in the industry. Monopolies are price makers, they can set the prices high and can still make abnormal profit in the long run because there will always be a demand for the good/service they are providing. Goods/services provided by monopolies are usually inelastic.

**Comment [A16]:** An answer to the question is provided. Diagrams are included and applied, there is some error in diagram 2. Relevant theory is explained reasonably well and an example is offered.

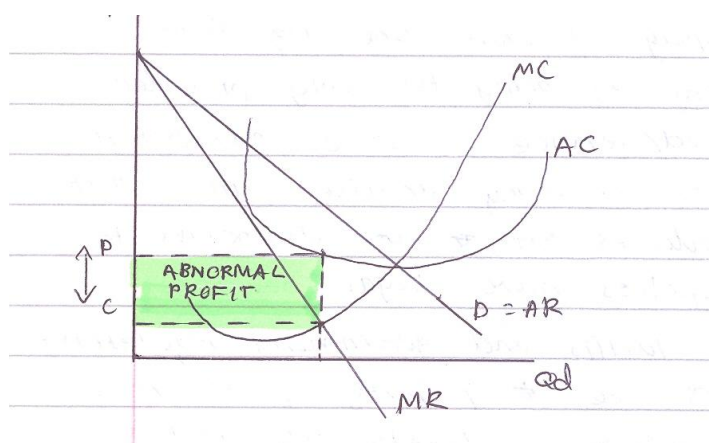
Level 3 7/10 marks.

**Comment [A17]:** Definition given.

**Comment [A18]:** Unjustified assumption.

**Comment [A19]:** Goods are not elastic, demand is elastic.

**Comment [A20]:** Errors in the diagram, abnormal profit is incorrectly labelled. Price is not indicated using the demand curve.



The diagram shows the abnormal profit a monopoly can achieve when profit maximising. This is where  $MR=MC$ , they can set the price of the good/service much higher than the cost and can have

abnormal profit. This can be achieved in the long run because there are many barriers to entry for entering the industry where monopolies are present. Barriers such as patents, tariffs and government regulations make it difficult for firms to enter the industry. (Example, PLN being the only electricity provider in Indonesia.)

**Comment [A21]:** A relevant example.

Unlike monopoly, monopolistic competition consists of a large number of firms that provide similar goods/services but are different in some ways. Monopolistic competition has no barriers to entry making it very easy for firms to enter and exit the industry. Monopolistic firms can enjoy abnormal profit like monopolies but only in the short run. They make normal profit in the long run as new firms enter the industry. Different to a monopoly, some people have brand loyalty where they stick to one monopolistic firm because they believe the goods and services provided are of better quality than those produced by other firms who offer the same/similar good or service.

**Comment [A22]:** Some identification of similarities and differences.

In conclusion a monopoly is where one big firm dominates the industry by being the only provider of a good or service while monopolistic competition consists of many smaller firms that provide similar products but are distinctive to each other. Monopolies have legal barriers such as patents, tariffs and government regulations and physical barriers like property of resources or technological advances. Monopolistic firms have no barriers of entry allowing firms to enter and exit the industry freely.

**Comment [A23]:** There is an attempt to address the question but it lacks depth. There is some understanding of the specific demands of the question and some knowledge of relevant economic theory, however there are also errors.

Level 2 8/15 marks.



### HL P1 SAMPLE C

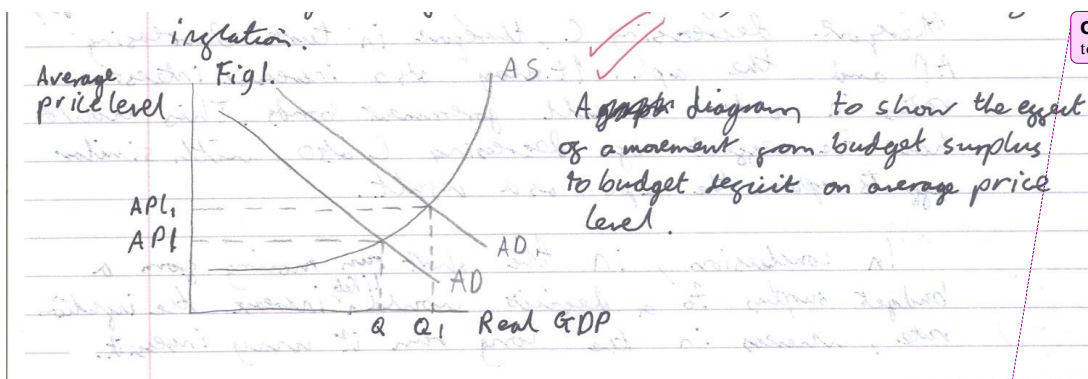
3. (a) Explain what might happen to the level of inflation if a government decides to move from a budget surplus to a budget deficit.

A budget deficit arises where a government spends more than it receives in taxation, similarly a surplus is a situation where tax revenue is greater than public spending. The movement from a budget surplus to a budget deficit would probably, but not necessarily, mean an increase in government spending. Government spending is a determinant of aggregate demand, as shown by the formula  $AD = C + I + G + (X - M)$ . An increase in aggregate demand would likely lead to an increase in the average price level, representing inflation. Therefore a move from a budget surplus to a budget deficit would likely increase the rate of inflation.

**Comment [A24]:** Definitions are provided

**Comment [A25]:** An awareness of different explanations.

**Comment [A26]:** Limited definition of inflation, no mention of "sustained".



**Comment [A27]:** The diagram is used to answer the question.

The movement from AD to AD1 represents the effect of the increase in government spending, or decrease in taxation on aggregate demand. The increase in government spending would increase G and the decrease in taxation would likely increase C in the formula  $AD = C + I + G + (X - M)$ . The increase in government spending or decrease in taxation or both are the ways in which the government would move from a budget surplus to a budget deficit. The increase in G and C shifted AD to the right. This had the effect of increasing the average price level from APL to APL1. This would occur in reality providing AS did not shift to the right, it also assumes ceteris paribus in terms of the other determinants of aggregate demand. In terms of the circular flow of income a budget deficit tends to increase the flow of income and spending, one other possibility is that the impact might be to increase imports, if that were to happen then the effect on inflation would be less obvious, arguably this is what has happened to the United States where its budget deficits of many years have contributed to a trade deficit rather than inflation.

**Comment [A28]:** A good example.

In conclusion if a government decided to move from a budget surplus to a budget deficit the impact on inflation would be to raise inflation ceteris paribus.

**Comment [A29]:** A good answer to the question, there is a clear understanding of the specific demands of the question. Terms are defined and relevant theory is clearly explained and applied.

Level 4 9/10 marks.

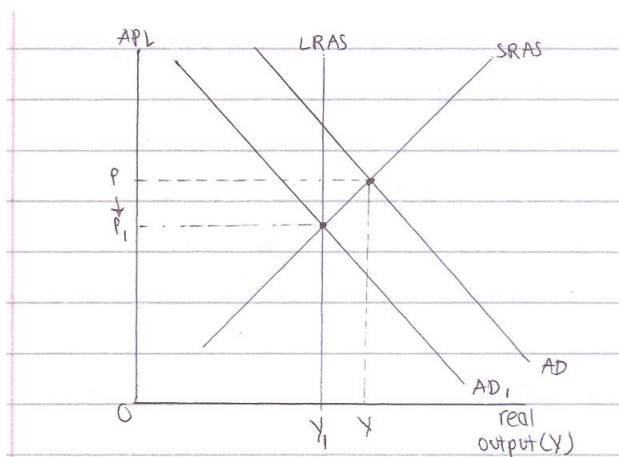
**Comment [A30]:** Level 4 9/10 marks.

**Comment [A31]:** Definition given.

- (b) To what extent is an increase in interest rates the most effective cure for inflation?

Inflation is a persistent increase in the average price levels of an economy. One of a government's main economic goals is price stability, and this may be achieved by attempting to restrict inflation to specified low target levels. Most governments, however cannot avoid inflation happening and when it does happen, they have a range of solutions to stop the rate rising further. Increasing interest rates is considered nowadays to be the most effective weapon in fighting against inflation, this is a form of monetary policy. This is because it encourages consumers to save rather than spend given

that they will get higher returns on their savings and also because credit is less freely available. Therefore it would reduce consumer demand, given that consumer demand is a determinant of aggregate demand it may decrease aggregate demand and therefore (assuming AS remains the same) decrease the average price level.



**Comment [A32]:** Diagram uses average price level which would mean that a reduction in the APL is deflation. The diagram is explained.

The increase in interest rates shifts the AD curve to the left, from AD to AD1, and by doing so decreases the average price level as well, from  $p$  to  $p_1$ , thereby reducing inflation. There are however, limitations with the use of interest rates to control inflation, namely that increasing interest rates may impede economic growth, this is shown by the movement of real GDP from  $Y$  to  $Y_1$ . An increase in interest rates would likely lead to a decrease in investment, while this may be a good thing in terms of controlling inflation, because credit is more expensive, businesses are less likely to expand. They may even choose to relocate overseas where credit is more freely available. This could lead to an increase in unemployment. Unemployment is likely to be the consequence of any reduction in aggregate demand however. Another problem with interest rates may be the impact on the exchange value of the currency, higher rates may attract portfolio money and cause an appreciation of the currency, this may make it more difficult to export and imports may increase resulting in a trade deficit. Increased import prices may worsen inflation.

**Comment [A33]:** There is evidence of synthesis.

In the long term a more effective cure may be the use of supply side policies. These aim to shift the long-run aggregate supply of the economy to the right, and in doing so they will cause GDP to rise as well as the average price level to fall. However with these the results are not seen until the long run, the advantage of interest rate changes is that they are more likely to be short term. So the extent to which interest rate changes might be an effective cure for inflation might depend on whether we talk about the long term or the short term and also on whether or not inflation is imported by a higher exchange rate.

**Comment [A34]:** There is an understanding of the demands of the question. Relevant economic theory is explained and applied. There is an attempt at evaluation but alternative policies have not been discussed. One line of argument pursued well.

**Comment [A35]:** Level 3 12/15 marks.

### HL P1 SAMPLE D

3. (a) Explain what might happen to the level of inflation if a government decides to move from a budget surplus to a budget deficit?

Inflation is an increase in the average price level. A budget surplus is when a government spends less than its revenue. A budget deficit is when a government spends more than its revenue. If a government decides to move from a budget surplus to a budget deficit this means it is spending more than its revenue.

**Comment [A36]:** Limited definition of inflation, no mention of "sustained".

**Comment [A37]:** Some sense of what a budget surplus and a budget deficit are.

The level of inflation could decrease because if the government spends more such as investing in projects, it would create employment because it creates demand for the workforce. The workforce would get income and that money could be spent on goods and services. Firms would then respond and produce more to meet the increased demand. Assuming there are economies of scale, the average cost per good or service would decrease. The government decision to move from a budget surplus to a budget deficit would decrease inflation.

**Comment [A38]:** An illogical line of reasoning. The response shows evidence of considerable confusion.

However if the government spends more than its revenue. This means that the government is borrowing from a source and in the long run the government needs to pay off its debt. This could lead the government to searching for additional sources of income. One solution is a tax. A government could increase tax to gain more revenue to pay off the debt. However an increased tax may lead to inflation because it creates the expectation that prices may continue increasing. Here the government's decision to move from a budget surplus to a budget deficit would increase inflation.

**Comment [A39]:** Some confusion.

**Comment [A40]:** An extremely limited response. A definition is offered that shows some understanding of the topic. However beyond that the response does not develop in a logical manner and a meaningful answer to the question is not achieved. Contradictory statements at the end of the final paragraph.

- (b) To what extent is an increase in interest rates the most effective cure for inflation?

Inflation is an increase in the average price level. Interest rates to some extent can be the most effective cure for inflation because increasing or decreasing interest rates would affect spending which in turn would cure inflation.

**Comment [A41]:** Level 1 3/10 marks.

**Comment [A42]:** Again an imprecise attempt to provide a definition.

This is because when interest rates are increased, people would save more, therefore they would spend less. They would spend less because they have less disposable income which means there would be less demand. When there is less demand, firms would produce less, because firms produce less, the cost of production would be cheaper decreasing the average price level.

However, because firms produce less that means there is a smaller demand for a large workforce. So firms would cut down the workforce to adapt to the current production level, creating unemployment. There would also be less investments because it is much more beneficial to save in banks because of the increase in interest rates.

But a government could also cure inflation by decreasing interest rates. By decreasing interest rates it would discourage people to save creating incentives for them to spend. They have an incentive to spend because they have more disposable income because they save less. That means there would be higher demand for goods and services. When there is a higher demand firms would produce more. As the level of production increases the average cost would decrease because of economies of scale. This could lead to a decrease in the average price level.

**Comment [A43]:** Very flawed reasoning.

**Comment [A44]:** A very weak response throughout. Theory is confused and there is no successful attempt to appropriately address the question. Definitions are weak, there is a lack of economic knowledge.

**Comment [A45]:** Level 1 3/15 marks.